July 2016

Systematically navigating an uncertain post referendum Europe

- Global financial markets rattled by Brexit
- Market sentiment and fundamentals at the mercy of politics
- Risk appetite indicator: Counter-cyclical buy signal

The month of June 2016 was a month where time would not prevail above the unexpected. Close to three and half years after David Cameron's conservative party first proposed a referendum on the United Kingdom's place within the European Union and after months of campaigning the UK voted on the 23rd of June to leave the EU sending hysteria across global financial markets. In the run up to the vote polls were tied neck and neck, which caused financial markets some unrest but these jitters were to abate as the voting closed in and the market began to price in a 90% probability of remain. Investor complacency was such that in the week running up to the vote European equity markets rose on average 7%.

The scenario was turned on its head in the early hours of Friday 24th as the shock of the result lead markets sharply lower at the open. The pound Sterling fell to levels not seen since 1985, the EuroStoxx 50 fell 8.6% it's biggest one-day loss in over thirty years and the S&P 500 fell 3.6% in its worst day of 2016. The outperformers on the day were the safe havens; high quality fixed income government and corporate securities, the U.S. dollar, the Japanese Yen and gold, which recorded gains. Swiss equity markets outperformed their peers relatively, the SMI lost 3.4% which can be largely attributed to the positive effects from the SNB interventions on the foreign exchange market, as it continued to follow its mandate of price stability.

As we close out this month and the dust settles, asset recovery has been impressive with the FTSE 100 closing above levels seen before the Brexit vote and close to 10% higher than the lows of Friday 24th. As well as this, US markets have also witnessed similar moves with the S&P 500 edging back into positive territory YTD and the EuroStoxx 50 trimming its loses, nevertheless still down 13% for the year in local currency terms. European yield curves continue to trade at record low levels, which are having a positive effect on global credit markets. On the currency front, the obvious winners from all of this volatility have been the USD and Japanese Yen which have strengthened relative to their currency pairs, the Swiss Franc remained stable as a result of Foreign Exchange interventions with the British pound being the obvious loser, down close to 12% against the CHF and EUR.

Consumption in the driving seat as the monetary environment dithers

This month has seen the sub-indicator "Consumption" take the initiative in driving our fundamental asset allocation model. The strength in consumption can be mostly attributed to the healthy trends seen in US personal spending, which has followed through from the spring and boosted GDP from the softer readings of Q1.

Monetary environment: With European inflation rates still very much subdued and the commencement of the European Central Bank's corporate sector purchase programme (CSPP) in June, as well as the continued rise in the Japanese component of monetary policy the model signals a favourable environment for equity investments. In spite of this the US term spread increased since last month as a result of June's FOMC meeting, it is important to note that thus far FOMC projections for rate hikes have been well ahead of the market. Across to emerging markets inflationary pressures and PMI's remain lacklustre which points to further monetary accommodation, something which to an extent has been pre-empted as the referenced government bond components of Emerging Markets dropped in May.

Industry: The softened trend in the industrial sentiment component continues in the US with weakened manufacturing output and business equipment spending continuing to be affected by the cutback in the energy industry and the stronger dollar, the Fed will be keeping a watchful eye. Japan's manufacturing industry continues to look to Abenomics as it falls for the sixth consecutive month as a result of the repeated waves of deflation and surging strength of the Yen. Our model continues to point to Europe for momentum in industrial sentiment and output.
Consumption: Consumption has bounced back healthily from the last couple of months with the US being the primary driver. US personal spending increased from last month as households demand increased for automobiles, airfares and other goods. Disposable income in May rose less than a month ago. Encouraging signs were also visible across the pond in Europe as consumer confidence rose to its highest level since January. Immediate weaknesses in consumption are un-warranted. Nevertheless, changes in consumption will be monitored as the fall-out from Brexit materialises.
Valuation: As a result of the current market turmoil, our asset allocation model points to the fact that US equities remain expensively valued, with forward Price to earnings ratios well above their historical median. The over reactions in European equities post Brexit has increased the attractiveness in valuations of European and Swiss equities even though the earnings picture is likely to deteriorate in the coming months. Our asset allocation model continues to show Emerging markets have been the clear beneficiaries of late, with valuations at attractive levels backed up by decent growth prospects and loose monetary policy.

Risk appetite indicator: Counter cyclical buy signal

From the end of May until the third week of June Eniso Partners has been running at a reduced equity quota as a result of our Risk Appetite indicator signalling a cautious psychological environment for stocks. Three out of four sub-indicators have significantly deteriorated with "Money Flow" and "Hedging Demand" leading

Risk appetite indicator: four out of the five indicators groups point to "buy"

	Number of Indicators	*Current Signal*	*1 Week*	*1 Month*	*3 Months*
MONEY FLOW	31	Buy	↘	↘	↗
SURPRISE EFFECT	17	Buy	↗	↗	↗
MARKET BREADTH	24	Buy	↘	↘	↗
HEDGING DEMAND	7	Sell	↘	↘	↘
MARKET RISK	37	Buy	↘	↗	↗
OVERBOUGHT / OVERSOLD		Oversold			
RISK APPETITE INDICATOR	**116**	**BUY**	↘	↘	↗

the pack. While the weakness of "Money Flow" can be attributed to increased shift in investor's allocation to defensive sectors, the sub-indicator "Hedging Demand" was affected by an increased demand for protection against tail risk events on stock markets. Driven by a decrease in political risk following polls that reflected a high probability of Britain to stay in the EU, investor sentiment quickly recovered in the second half of June and Eniso's risk appetite indicator generated a buy signal for equities. Despite or more precisely thanks to Brexit this buy signal is still valid. The unexpected outcome of the vote led to an abrupt and harsh increase in risk aversion, being best shown by a massive spike in demand for put options and in volatility measures. The fall in risk appetite was so strong, that Eniso's risk appetite indicator signalled panic in the markets and therefore an anti-cyclical oversold condition.

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